



**OFFICE OF THE UNDER SECRETARY OF DEFENSE**

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**OCT 24 2006**

COMPTROLLER

**MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (FINANCIAL  
MANAGEMENT AND COMPTROLLER)  
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL  
MANAGEMENT AND COMPTROLLER)  
ASSISTANT SECRETARY OF THE AIR FORCE  
(FINANCIAL MANAGEMENT AND COMPTROLLER)  
DIRECTORS OF THE DEFENSE AGENCIES  
DIRECTORS OF THE DEPARTMENT OF DEFENSE FIELD  
ACTIVITIES  
USSOCOM, DIRECTOR OF SORR – J8  
ASSISTANT TO THE SECRETARY OF DEFENSE  
(NUCLEAR, CHEMICAL AND BIOLOGICAL DEFENSE  
PROGRAMS)**

**SUBJECT: Military Equipment Valuation Project Business Rules**

In 2002, the Federal Accounting Standards Advisory Board issued Statement of Federal Financial Accounting Standards No. 23, "Eliminating the Category National Defense, Property, Plant and Equipment," that requires the capitalization and depreciation of military equipment.

The June 8, 2005 Deputy Chief Financial Officer memorandum entitled Military Equipment Valuation Project Business Rules, was published to assist in the implementation of this objective.

While these business rules addressed many key factors affecting the valuation of military equipment, some items, such as the useful life and capitalization threshold for military equipment, how group and composite depreciation would be implemented as part of the military equipment valuation process, and the allocation of Program Management Office (PMO) costs were not addressed.

Additional business rules enclosed in the attachment provide guidance on these issues. The Office of the Under Secretary of Defense (Acquisition, Logistics and Technology), Property and Equipment Policy Office applied these rules as they developed the military equipment valuation baseline.

As the baseline matures and the Department moves into the second phase of the military equipment valuation process, these business rules (as applicable) will be addressed in an update to the Department of Defense Financial Management Regulation, Volume 4, Chapter 6, "Property, Plant and Equipment."

Questions concerning this memorandum should be directed to Mr. Ric Sylvester, Deputy Director, OUSD(AT&L), Property and Equipment Policy Office, at 703-604-6350 x121.

A handwritten signature in black ink, appearing to read "Robert McNamara", written in a cursive style.

Robert McNamara

Acting Deputy Chief Financial Officer

Attachments:

As stated

## ***Summary of Business Rule for Group or Composite Depreciation***

### **Background**

In the Congressional budgetary appropriations process, a single budgetary procurement line<sup>1</sup> may be used to acquire a number of different, but similar, end items. To illustrate, a single procurement line may be used to acquire a “family” of construction equipment, such as bulldozers, scrapers, and excavators. Some items may meet or exceed the Department of Defense (DoD) capitalization threshold for military equipment, while other items may not. Items acquired under a single procurement line may be recorded as individual items in a property system (without cost details) for accountability purposes, but often the total acquisition cost of the procurement line, rather than the acquisition cost of the individual items, is recorded in an accounting system.

### **Issue**

The ME valuation methodology identifies program expenditures, using an automated approach, and associates these expenditures with the items being acquired. The objective is to link the expenditures directly to individual items. However, current Department accounting systems do not always support item level valuations. To address this, the Department was required to develop an approach for valuing multiple items acquired under a single procurement line.

### **Approach**

The Statement of Federal Financial Accounting Standards (SFFAS) No. 23, *Eliminating the Category National Defense Property, Plant and Equipment (PP&E)*, amends SFFAS No. 6 *Accounting for Property, Plant and Equipment*, to include the following language, “A composite or group methodology, whereby the cost of PP&E are allocated using the same rate, is permissible.”

The related footnote states, “The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and services lives.”

Until systems and processes are in place to establish, maintain and update the baseline value for multiple items acquired under a single procurement line, the Under Secretary of Defense (Acquisition Technology and Logistics) Property and Equipment Policy (P&EP) Office will continue to value these assets. The P&EP Office (with support from Component representatives) will work with the program management offices to execute this rule for valuing military equipment.

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<sup>1</sup> The total of a procurement line is presented in Budget Exhibit P-1 (Procurement Line). Estimated cost and quantity data on end items that make up a procurement line are customarily provided in Exhibit P-40 (Budget Item Justification); in some cases, additional end item data is provided in Exhibit P-5 (Weapons System Cost Analysis).

As a basic rule, end items should be valued individually. The Department of Defense recognizes this objective and is developing the Capital Asset Management System – Military Equipment, Increment 2, to support the specific valuation and depreciation of individual items.

However, baseline data is not always available to value individual end items. Consequently, baseline valuation is limited to the level of available expenditure/financial data. To illustrate, if baseline expenditure data is available at the item level for the items that comprise the procurement line, the related items should be valued individually. If expenditure data is available only at the procurement line level, and if a determination can be made that some of the items have a unit cost that exceeds the capitalization threshold, then the entire procurement line should be valued as a single item purchase. The language in the accounting standards relating to Group and Composite depreciation supports this approach.

This rule for baseline valuations addresses the following four scenarios:

- (1) Expenditure data is available only at the procurement line level and a determination has been made that **some** of the items being acquired under this procurement line have a unit cost in excess of the capitalization threshold;
- (2) Expenditure and unique identifier data is available at the end item level, and **all** of the items in the procurement line have an estimated acquisition cost equal to or greater than the DoD capitalization threshold;
- (3) Expenditure and unique identifier data is available at the end item level, and **some, but not all**, of the items in the procurement line have an estimated acquisition cost equal to or greater than the DoD capitalization threshold; and
- (4) Expenditure and unique identifier data is available at the end item level, but **none** of the items in the procurement line have an estimated acquisition cost equal to or greater than the DoD capitalization threshold.

Scenario (1) – Expenditure data are available only at the procurement line level, and a determination has been made that **some** of the items being acquired under this procurement line have a unit cost in excess of the capitalization threshold.

- Value the entire procurement line as a single item.
- Program managers should provide a weighted average estimate of the useful lives of end items that comprise the procurement line for depreciation purposes.
- The weighted average should consider the relative cost and useful lives of the individual assets included in the procurement line item. For example, based on similarly valued assets, the weighted average would be computed by adding the engineering estimates of the useful lives of the individual assets included in the procurement line and then dividing the result by the number of items procured.
- Since there is no monetary value assigned to the items in this scenario nor is there a continuing parent-child relationship established between the items acquired and the program cost, the impact of asset disposal must be estimated using one of the following approaches;
  - If losses are generally in line with anticipated disposals, the program's military equipment value and related accumulated depreciation should be adjusted to reflect an estimate of disposals. Until more accurate information is available, this

estimate should be based on the amount of accumulated depreciation posted each year.

- In exceptional cases where significant and unanticipated losses occur, a write down based on a percentage of the loss compared to the remaining net book value of the related assets, should be recognized.

Scenario (2) – Expenditure and unique identifier data are available at the end item level and **all** of the items in the procurement line have an estimated acquisition cost equal to or greater than the DoD capitalization threshold.

- Value the end items in accordance with Baseline Valuation Methodology.
- Account for disposals in accordance with the Baseline Valuation Methodology.

Scenario (3) – Expenditure and unique identifier data are available at the end item level with **some** end items having an estimated acquisition cost equal to or greater than the DoD capitalization threshold and **others** have an estimated acquisition cost of less than the DoD capitalization threshold.

- For items with an estimated acquisition cost equal to or greater than the DoD capitalization threshold:
  - Value the end items in accordance with Baseline Valuation Methodology;
  - Account for disposals in accordance with the Baseline Valuation Methodology.
- For items with an estimated acquisition cost below the DoD capitalization threshold:
  - Expense items

Scenario (4) –**All** items in the procurement line have an estimated acquisition cost of less than the DoD capitalization threshold.

- Expense all items.

## ***Summary of Business Rule on Military Equipment Useful Life***

### **Background**

Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, requires that depreciation expense be calculated on property, plant and equipment (PP&E) over the PP&E's estimated useful life. SFFAS No. 6, Footnote 17, defines useful life as the normal operating life in terms of utility to the owner. It also provides that estimates of useful life must consider factors such as physical wear and tear and technological change (e.g., obsolescence).

The Standard also describes depreciation as the method of allocating the cost of tangible capital assets, less salvage value, over the estimated useful life of the asset in a systematic and rational manner. The Department has established military equipment (ME) useful lives for various purposes, such as for budget estimates and must also develop meaningful useful life estimates for meeting ME financial reporting requirements.

### **Issue**

The Department must design a strategy that provides for a sound Military Equipment (ME) useful life policy. A policy based on grouping similar types of ME into asset classes<sup>1</sup> and calculating an average useful life for each class or category was considered, however, the development of such a strategy was inhibited by Department data limitations.

Department data sources for ME valuation include asset acquisition date and asset disposal date data. Normally, this data would be sufficient for deriving useful life estimates since they provide a historical record of actual experience. However, historical records include the extended useful lives resulting from Service Life Extension Programs (SLEPs). The historical record does not provide the visibility necessary for determining the effects of SLEPS on end item useful lives.

Germane to the topic of useful life are the effects of prolonged combat operations on military equipment. The House Committee on Appropriations recently reported that one to two months' worth of operations in Iraq is equivalent to roughly one year's worth of peacetime activity.<sup>2</sup> In an April 2005 Report to Congress<sup>3</sup>, the Office of the Secretary of Defense provided information on the repair, replacement, and recapitalization requirements of U.S. ground force equipment employed in Iraq and Afghanistan. The report is based on a review initiated by the Secretary of Defense<sup>4</sup> to assess the harsh operating conditions and high utilization rates in combat deployed to

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<sup>1</sup> For example, cargo aircraft, bomber aircraft, helicopters, ships (by class), ground combat tracked vehicles.

<sup>2</sup> House Committee on Appropriations, *Department of Defense Appropriations Bill, 2005*, Report 180-553 (June 18, 2004), pp. 107-108.

<sup>3</sup> Office of the Secretary of Defense, *Ground Force Equipment Repair, Replacement, and Recapitalization Requirements Resulting From Sustained Combat Operations*, Report to Congress, April 2005, p iii.

<sup>4</sup> Secretary of Defense Memorandum to Director, Office of Management and Budget (March 26, 2004).

those locales. In Iraq and Afghanistan, equipment usage rates have run two to eight times higher than comparable peacetime rates. Equipment is also employed in harsher environments and in more demanding ways in combat missions.

The Army has hypothesized that, due to high utilization and a harsh operating environment, vehicles are experiencing systemic degradation beyond what normal maintenance and Reset activities can recover. Reset consists of a series of actions to restore units to a desired level of combat capability after returning from contingency operations. For equipment, these actions consist of cleaning, inspecting, and repairing, as well as replacing battle losses, washouts (equipment that is not economical to repair) and obsolete systems. To capture the degradation, the high utilization rates (in miles) are converted to an increased aging rate (in years).

There is difficulty in formalizing the method of accelerated aging. The crux of the problem lies in quantifying exactly how to convert between utilization and age. The RAND Corporation has recently published a study of how M1 tanks age, quantifying how aging affects the readiness of the tank as a whole, as well as characterizing the effects of aging on the tank's various sub-systems. An Army Aging Study is using this methodology as a model for further work on other key military systems: starting with HMMWV, AH-64, and M2/3.

### **Approach**

Given the foregoing, the best data currently available for estimating useful lives of ME are Program Office estimates, which are based on Engineering estimates, and historical information on asset utility/usage.

The Department shall use the PMO estimates of useful life, exclusive of the effects of Service Life Extension Programs (SLEPs).

The Department shall use PMO estimates of changes in useful lives resulting from SLEPs and, after the completion of the SLEP, adjust useful life estimates accordingly.

The Department shall periodically evaluate the effects of excessive use on the estimated useful lives and adjust useful life estimates accordingly.

In addition, as information technology enables Department Managers to factor in the impact of differences in usage such as those described above, the Department will reconsider establishing general category guidelines relative to equipment useful lives.

## ***Summary of Business Rule for Recording Program Management Office (PMO) Costs***

### **Background**

Paragraph 26 of The Statement of Federal Financial Accounting Standards (SFFAS) No. 6 entitled, *Accounting For Property, Plant and Equipment (PP&E)*, states that, “Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use.” The standard then provides the following listing as an example of what might be included:

- amounts paid to vendors;
- transportation charges to the point of initial use;
- handling and storage costs;
- labor and other direct or indirect production costs (for assets produced or constructed);
- engineering, architectural, and other outside services for designs, plans, specifications and surveys;
- acquisition and preparation costs of buildings and other facilities;
- an appropriate share of the cost of the equipment and facilities used in construction work;
- fixed equipment and related installation costs required for a building or facility;
- direct costs of inspection, supervision, and administration of construction contracts and construction work;
- legal and recording fees and damage claims;
- fair value of facilities and equipment donated to the government; and
- material amounts of interest costs paid.

A review of this listing is inconclusive as to, (i) whether Program Management Office (PMO) costs should be included in the cost of the related assets and (ii) what should be included in PMO costs.

### **Issue**

Per applicable accounting standards, the Department may generally be required to include PMO costs when computing the total costs of the related Military Equipment (ME).

Indirect costs that are significantly removed from the “hands on” effort associated with acquiring an asset, similar to the costs normally recovered through a general and administrative rate, are not referenced in SFFAS # 6. However, direct costs of inspection, supervision and administration of construction contracts are. It is not clear whether this requirement to include inspection, supervision and contract administration is specific to construction contracts, for which these costs might be significant, or is a general requirement.



Research, Development, Test and Evaluation (RDT&E), costs incurred during the RDT&E phase of a program, including related PMO costs, are generally expensed in accordance with the existing policies.

Estimates of program management costs based on Department reports to Congress equate to approximately .75% of the total of the procurement and RDT&E appropriations. Additionally, the Department's cost accounting systems have limited ability to capture and separately identify Program Management costs.

### **Approach**

There is a strong likelihood that the majority of the identified PMO costs related to military equipment would be expensed since they relate to Research and Development efforts.

Therefore, based on the preceding analysis, Program Management Office costs are to be expensed for baseline purposes.

The Department will reassess this position in the future as improvements to the Department's accounting system enhance the ability to cost-effectively capture and analyze the PMO cost information.

***Summary of Business Rule With Corresponding Analysis on  
The Department of Defense  
Military Equipment Capitalization Threshold***

**Background**

The Department is moving away from a standard capitalization threshold for all types of General Property, Plant, and Equipment (GPP&E) to one that is tailored to real property, military equipment, and general property asset categories.

All items of military equipment, which previously were considered National Defense PP&E, are now classified as General PP&E, pursuant to Statement of Federal Financial Accounting Standards (SFFAS) No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment*.

For financial reporting purposes the Department is treating military equipment (ME) as a subset of General PP&E and reporting it separately. The primary difference between ME and the balance of General PP&E is that ME is generally procured for tactical/battlefield situations.

Prior to SFFAS No. 23, the acquisition costs for military equipment items classified as National Defense PP&E were expensed in the period incurred. Now that military equipment is classified as General PP&E, the Department is pursuing a major initiative to capitalize and depreciate military equipment end items.

Paragraph 13 of SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, states that capitalization thresholds should be established by Federal entities rather than centrally by the Federal Accounting Standards Advisory Board. Federal entities are diverse in size and uses of PP&E, and must consider their own financial and operational conditions in establishing an appropriate threshold or thresholds.

**Issue**

The capitalization threshold for General Property and Equipment had been set at the then existing threshold for using procurement funding, i.e., generally assets with a unit cost of \$100,000. Some within the audit community have expressed concern that this threshold might be too high and might exclude significant amounts of equipment from valuation.

Initially \$100,000 was the threshold used to identify the military equipment (ME) that should be capitalized. However, during the valuation effort, this threshold was modified for two reasons. First, accounting systems were not always able to associate individual military equipment items with the related expenditures. When this occurred the concept of Group and Composite depreciation was used and the entire line was valued as a single asset. Second, the Department “owned” billions of dollars in wheeled vehicles, with unit costs between \$50 thousand and \$100 thousand. The Department judgmentally

determined that, based on the magnitude of the dollars involved, these vehicles should be capitalized.

A study was initiated to assess the revised threshold, however, absent a consolidated universe of military equipment assets, the study could not be structured in a way to make it statistically valid.

Alternatively, an assessment of the three tier threshold focused on Marine Corps assets that had unit costs between \$50 thousand and \$100 thousand and that would therefore be expensed under the proposed three tier threshold criteria. Most of these assets could be categorized as personal equipment (including weapons), radios, commercial items, vehicles or shelters. The Department believes that most items in this dollar category will have a useful life of less than two years when they are used for the purpose intended and that as such the items should be expensed.

### **Approach**

The Department believes that the analysis referenced above, plus the language in Statement of Federal Financial Accounting Standards No. 23, that gave the Department flexibility in establishing the ME baseline, support a decision to value ME using the following three criteria.

1. ME assets with a unit cost equal to or greater than \$100,000, where the cost of individual end items is known or can be calculated using the baseline valuation methodology, and where end items can be uniquely identified, will be capitalized as separate items.
2. ME assets having a unit cost of all or some of the end items is in excess of \$100,000 and where end items cannot be uniquely identified will be capitalized at the total program cost level.
3. ME assets that have a unit cost of \$50,000 or more, where the information is unavailable or it is impractical to assign costs by end item, and where the items to be acquired are homogenous self propelled vehicles, will be capitalized on a group basis.